Stefan Ingves: The Riksbank and monetary policy

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at the School of Business, Economics and Law, Göteborg University, Göteborg, 23 May 2006.

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Let me begin by thanking you for the invitation. It is always a pleasure to have the opportunity to come and talk about monetary policy and our work at the Riksbank - but I shall refrain from commenting on whether it is always a pleasure for the listeners. I hope that you will in any case get a picture of our view of the economy and inflation prospects and of our method of how we conduct monetary policy.

I shall begin with a rough outline of what I intend to discuss in my speech and the main conclusions:

First, I shall describe my view of the current monetary policy situation. A brief summary of my conclusions is:

- The upswing in the international economy appears to have been slightly stronger than we envisaged in the February Inflation Report.
- With regard to Sweden, the statistics received since the Inflation Report was published indicate that the economy has developed approximately in line with our assessment, although inflation temporarily rose more rapidly than anticipated as a result of developments in energy prices.
- Our earlier monetary policy considerations from February and April still apply to a large extent. Monetary policy will need to be less expansionary in future. The pace at which the interest rate should be increased will depend as usual on the inflation outlook and on other macroeconomic developments.

Following the discussion of the current economic situation, I will describe the principles guiding monetary policy and then touch on some of the practical problems we encounter. The most important points in this discussion are as follows:

- Given our overall objective to maintain price stability, we also endeavour when making decisions on the repo rate to contribute to the stable development of the real economy.
- This is done by not aiming to bring inflation back on target as quickly as possible in every single situation. When there is a deviation from target, our ambition is normally to return inflation to target within two years.
- Our incomplete knowledge of structural changes and other developments in the economy means that monetary policy cannot be expected to fine-tune economic conditions to any great extent.

I shall now discuss the current monetary policy situation in greater detail.

The current monetary policy situation

Growth in the world economy has been high and stable in recent years. In the United States, GDP growth remained strong in 2005, despite natural disasters and high oil prices. The economic expansion in China has now been in progress for a number of years, and together with the recovery in the Japanese economy it contributed to high growth in several Asian countries last year. Growth in the euro zone has been relatively weak, but last year there were signs that economic activity was beginning to improve there, too.

At the same time as growth in demand in the world economy has been strong, price pressures have been held back. Although oil and other commodities have become significantly more expensive for consumers, the general price increases have been relatively small on the whole. This can probably be partly explained by increasing international competition. The upswing in global economic activity has also characterised developments in the Swedish economy, which has grown strongly in recent years, with the exception of a slowdown at the end of 2004/beginning of 2005. Despite the good growth in demand, inflation has been low in Sweden. This is largely attributable to import prices excluding oil developing weakly and to cost pressures being held back, partly by the strong productivity growth and low capacity utilisation.

The development we envisaged in the February Inflation Report was that international growth would continue to be good. There were some question marks regarding developments in the United States and in the euro area, where preliminary statistics for the fourth quarter of 2005 were surprisingly weak. Our assessment was that this could largely be explained by transient factors and that the upswing could nevertheless continue, although possibly at a slightly slower rate.

Our assessment for the Swedish economy was that domestic demand would be strong over the coming years, with GDP growth peaking in 2006. The forecasts indicated that household consumption would rise and investment would continue to increase, but at a slightly slower rate than last year. We also envisaged continuing strong exports as a result of the good international activity.

With regard to the labour market, we could observe an apparent upturn in demand for labour and that there were many indications that employment in terms of both persons in employment and of hours worked would increase further. Economic resources were expected to become increasingly strained and the rate of wage increase to become gradually higher. However, we assumed nonetheless that the increase in cost pressures would be relatively moderate as a result of continuing good productivity growth over the coming years. All in all, inflation was expected to rise, although at a modest rate, as a result of dampening effects from the developments in productivity and import prices. Our forecast was that underlying inflation would rise gradually and approach the 2 per cent target a couple of years ahead.

This was the picture of developments painted in the February Inflation Report. What has happened since February? The world economy appears to have developed slightly more strongly than we foresaw then. New and revised national accounts figures have been published for the United States, parts of Asia and the euro zone. With regard to the United States, the statistics show that the end of 2005 and the beginning of 2006 were slightly stronger than we had assessed. For Asia the picture of a stronger development is even more evident. In the euro zone, developments during the fourth quarter were roughly as expected, but the indicators published since then point towards slightly more favourable developments there than was expected in February.

At the same time, the oil price has risen much more than expected and forward prices for oil have also risen. We can therefore assume that oil and petrol prices will remain at a high level for some time to come. This of course comprises an uncertainty factor for the economic assessment and it is difficult to ascertain what consequences it will have. The experiences so far indicate that the international economic upswing has been resistant to the increasing oil prices.

At home, a considerable amount of new statistics have been published since February, including the national accounts for the final quarter of 2005. GDP growth during the fourth quarter was slightly lower than expected, but for the year 2005 as a whole growth was nevertheless in line with our forecast because the outcomes for earlier periods had been revised upwards. The figures show that exports increased more than anticipated last year, which with hindsight is not surprising, given the strong international growth. On the other hand, both household consumption and investment were weaker during the fourth quarter than in our earlier forecast.

Judging by the recent economic indicators, developments so far this year have been better than at the end of 2005. The purchasing managers index for manufacturing and the National Institute of Economic Research’s quarterly business tendency survey indicate, for instance, that manufacturing activity improved from the middle of 2005 and that this development continued during the first quarter of this year. Developments in the labour market have also been positive in recent months. Employment has developed in line with our forecast, while the labour force has increased more than expected. Business tendency data also indicate that the upturn in employment will continue during the second quarter. All in all, I believe that this indicates that the slowdown at the end of last year was temporary, and that economic activity in Sweden this year has developed largely in line with the assessment in the February Inflation Report.

There has been turbulence in the financial markets recently, with a relatively large fall in share prices. Asset price changes can affect inflation indirectly in that they affect households’ wealth and thereby aggregate demand. Share prices can rise sharply over a long period of time and then recoil, without this being a sign of a more lasting decline. At present, it is not possible to draw any far-reaching conclusions from the recent stock market developments. As usual, the Riksbank is monitoring developments in asset prices and what they may mean for inflation and other macroeconomic developments.

With regard to inflation, the outcome for both March and April was higher than we had estimated in the Inflation Report. In April, the upturn in the consumer price index was 1.5 per cent on an annual rate and underlying inflation was as high. This was half a percentage point higher than expected in both cases, and the difference between our forecasts and the outcomes can largely be explained by unexpected price rises on a limited number of goods, primarily petrol, heating oil and electricity. As I mentioned earlier, there is reason to expect high oil prices for some time to come. It is therefore also probable that inflation will be above our earlier forecasts. A reasonable assessment is that this will mainly have consequences for developments over the coming year, but as I said before, there is considerable uncertainty regarding, for instance, the direct effects of oil prices on inflation and the indirect effects on other macro variables.

Our assessment in the Inflation Report was that inflationary pressures would increase over time as international and domestic cost pressures were pushed up by the continuing economic upswing. Monetary policy will therefore need to become less expansionary so that inflation does not exceed the target.

Of course, one can discuss the pace at which the interest rate should be increased. Market expectations in recent weeks have assumed a continued gradual increase in the interest rate from early summer, which I consider to be reasonable, given the developments we have seen since February. However, it is almost one month until I and my colleagues will meet for a new discussion of the monetary policy stance. At this meeting we will make a collective assessment of events since the previous forecasts were made.

The monetary policy strategy

Many may wonder why we increase the interest rate despite the fact that inflation is currently slightly below target and there is still spare capacity in the labour market. What must be remembered in order to understand why monetary policy needs to be brought gradually onto a less expansionary path is that it takes time for the economy to adjust to changes in the repo rate. This means, for instance, that we have not yet seen the full effect of the expansionary monetary policy we have conducted in recent years. It also means that interest rate decisions must be based on an assessment of how the economy will look a few years from now.

Let me describe how we usually reason when making interest rate decisions. This is also something described in greater detail in the document on monetary policy that we published last week.

The objective of monetary policy is to maintain price stability. This was established in the changes to the Sveriges Riksbank Act, which came into force in 1999. The Riksbank has specified this in the form of an inflation target, whereby the rate of change in the CPI should be 2 per cent with a tolerance interval of +/- 1 percentage point.

Stable prices are thus the objective of monetary policy in Sweden, as in all other countries in the industrialised world. The fact that the target has been formulated in this way is because price developments are the only thing that monetary policy *can* steer in the longer term. Long-term developments in growth and employment are essentially unaffected by changes in the interest rate. They are determined by factors such as productivity and the supply of labour and capital, as well as the way the labour market – and the economy as a whole – functions.

It is possible to say that monetary policy can *indirectly* create good conditions for an efficiently-functioning economy by maintaining inflation at a low and stable rate. The pricing and wage-setting systems function more efficiently if changes in general price levels are small and predictable. This makes it easier for companies and consumers to make wise decisions regarding investment, consumption and employment. The development of the Swedish economy during the 1970s and 1980s provides a particular indication of how failed investment and arbitrary distribution of income can result from high and fluctuating inflation.

In the short term, monetary policy also affects the economy's cyclical pattern. When we formulate our monetary policy we therefore try to do so in a way that contributes to the most favourable and stable macroeconomic development possible, without jeopardising the price stability target. In other words, we are not ”inflation nutters”, to use a phrase coined by my British colleague Mervyn King. This means that we do not set interest rates merely to ensure inflation is on target as quickly as possible in all situations.

It is very important to emphasise that the possibility to formulate monetary policy based not only on inflation prospects but also on how production and employment will develop has come about because the inflation target is currently firmly anchored in the economy. Everyone knows that we will adapt our monetary policy to attain the inflation target. During the years when the inflation target was new, confidence in the target was too shaky for the Riksbank to dare to give consideration to anything other than attaining the inflation target. However, flexible application of inflation targeting is nothing new if one looks at the monetary policy we have conducted in recent years, once confidence in our inflation target had been established. In practice, as I said, we do not aim to bring inflation back on target as quickly as possible in every situation. The Riksbank follows the principle of normally aiming to bring inflation back on target within two years after a deviation has occurred.

It is primarily in situations where inflation goes in one direction and the real economy, i.e. growth, employment, etc. goes in the opposite direction that there may be reason to bring inflation back on target at a more gradual rate. Economists usually describe these situations as the economy suffering a supply shock. A simple example can be when companies' costs suddenly increase, for various reasons. Companies then often increase their prices to compensate for the rise in costs, but they usually also reduce the resources they use in production. The result may then be that inflation exceeds the target, while economic growth slows down. If, in such a situation, monetary policy aims to quickly bring down inflation, capacity utilisation in the economy may fall further. These problems can be alleviated if monetary policy aims to bring inflation back on target more gradually in such situations.

In practice, of course, we must often deal with much more complicated situations than this type of textbook scenario. Take, for instance, the present situation. The high productivity growth we have experienced in recent years has led to a disruption – a positive one – in the supply side of the economy, while inflation has remained low. However, we have not yet experienced a clear conflict between the aims to attain the inflation target and to stabilise the real economy. The improved productivity has so far enabled a high growth rate without excessive strain on capacity utilisation in the economy. We have therefore seen scope to stimulate the economy by means of expansionary monetary policy.

At the same time, the low interest rate has contributed to a rapid increase in house prices and to an expansion in credit. We have felt some concern that the credit expansion and increases in property prices could go too far, with the risk that demand might fall sharply if there is an adjustment further ahead. However, these risks are difficult to quantify and they may lie far in the future. In this way, they do not easily fit into our usual analysis and forecasting work. We Executive Board members have nevertheless considered in our discussions that we should in some way take these risks into account, and this has been one of the pieces of the puzzle that explains our recent actions.

In practice, it is often difficult to estimate how lasting various structural changes and other economic developments will be. For example, both the Riksbank and other forecasters have been uncertain as to whether the strong productivity in recent years has been temporary or a more lasting change. Conducting monetary policy that has substantial stabilisation policy ambitions could thus risk reinforcing cyclical fluctuations rather than subduing them. The conditions for succeeding with an active monetary policy are also complicated in practice since it takes time before the full effects of interest rate adjustments are visible. One therefore should not expect monetary policy to be able to fine tune economic activity to any great extent.

There are also other reasons that limit the ambition to stabilise the real economy. The flexible application of our monetary policy must not diminish confidence in the inflation target. For this reason, it is important that deviations from the target should not be allowed to become too prolonged. This is why the Riksbank has chosen to aim under normal circumstances to bring inflation back on target within two years. One can say that this is a restriction we have placed on ourselves to create flexibility in an orderly manner.

At the same time, it is not appropriate to set restrictions for monetary policy that would be binding regardless of developments in the economy. There may – exceptionally – be situations where the consequences of bringing inflation back on target within two years may lead to unacceptable fluctuations in economic activity. It has sometimes been claimed that there is currently a risk that inflation could remain subdued over a long period of time, partly as a result of globalisation, and that this may mean that inflation is below target for longer than two years. We have made another assessment, as I mentioned earlier, but this type of situation is an example of when it might be appropriate to deviate from our normal target horizon. If we were to make the assessment that this type of situation had arisen, we would make it quite clear in advance. We also make clear how long we expect inflation to deviate from the target, and why we think this will happen, in connection with our monetary policy decisions.

Conclusion

Let me conclude with a brief summary of what I have just said.

I have given my views on the current monetary policy situation and described the principles that guide monetary policy. I have also mentioned some of the practical problems we face.

When it comes to the current monetary policy situation, my assessment is that the picture we painted of inflation prospects in the February Inflation Report still holds true to a great extent, although it now looks as though energy prices may contribute to higher inflation in the short term. Monetary policy needs to become less expansionary.

With regard to the monetary policy strategy, one important message has been that we do not always aim to bring inflation back on target as quickly as possible; we also give consideration to the real economy. We cannot rule out the possibility of situations arising where it may be necessary to set our sights further ahead than the time period normally used to guide monetary policy decisions. However, in this case we will make it clear in advance that we envisage such a development.

Thank you!